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Climate Change Governance and Reporting Regulations

Risks and opportunities for UK pension schemes

The DWP has announced the phased introduction of mandatory climate change governance and disclosure requirements for UK pension scheme trustees, aligned with the recommendations of the Task Force on Climate-related Financial Disclosures ("TCFD").

Whilst initially only mandatory for the largest of schemes, the recommendations are considered best practice for trustees to manage climate-related risks and opportunities.

In this note, we set out the TCFD recommendations and actions for those trustees looking to adopt them.

Climate change – risks and opportunities for UK pension schemes

Climate change and the actions taken by governments to combat its causes and effects, both now and in the future, will impact pension schemes.

The risks faced by businesses can be classed into two broad categories:

1. Physical Risks

Changes in assets and liabilities which are directly caused by changes in the climate, for example the impact on business operations due to extreme weather effects such as flooding, drought, sea level rises and heat.

This includes the potential impact of extreme weather events damaging company assets and infrastructure, supply chain disruption caused by the deterioration of natural resources as a result of climate change, the impact on staff productivity caused by changing working conditions and increases in inflation caused by greater scarcity of certain resources.

2. Transition Risks

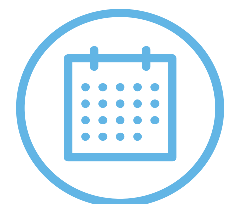
Risks associated with action by institutions to address climate change and the transition to a carbon neutral economy.

This may be caused by governments introducing limits on emissions, carbon tariffs or additional disclosure requirements. It also includes the risk of changes to the demand for certain products and services as consumers change their behaviours to take account of their impact on the climate.

Whilst there are clear risks associated with climate change, there will also be investment opportunities such as the increased demand for renewable energy assets and carbon capture and storage development.

New regulations – scope and timeframes

The new Occupational Pension Schemes Climate Change (Governance and Reporting) Regulations 2021 state that the largest UK pension schemes are to be subject to these obligations from 1 October 2021.



This includes occupational pension schemes with more than £5bn of net assets, along with authorised master trusts and authorised collective money purchase schemes. Schemes with more than £1bn of net assets will need to comply from 1 October 2022 and application to smaller schemes will then be reviewed in 2023.

Creating a robust governance framework for assessing and monitoring climate change risks and opportunities is best practice regardless of whether a scheme is captured in the first wave of these mandatory requirements.

The new climate change regulations are a natural extension of recent amendments to the Occupational Pension Schemes (Investment and Disclosure) Regulations 2005 which promoted the consideration of financially material Environmental, Social and Governance (“ESG”) factors more generally within trustees’ investment decision-making processes.

TCFD recommendations

The Financial Stability Board's Task Force on Climate-related Financial Disclosures ("TCFD") is a global, independent, private sector led group established in December 2015. In June 2017, the TCFD recommended a series of disclosures relating to climate change and its effects.

The UK government, through its Green Finance Strategy, stated its expectation that all listed companies and large asset owners, including pension schemes, will produce TCFD-consistent disclosures by 2022.

The TCFD's recommendations can be split into **four thematic areas**. Below we outline the requirements under each area and suggested next steps for pension scheme trustees to consider when implementing them.

1. Governance

Establish and maintain oversight of relevant climate risks and opportunities for your scheme.

Trustee actions:

- Define clear roles and responsibilities for the management of climate-related risks and opportunities.
- Make climate change a regular agenda item at meetings.
- Formalise and document governance policies, including roles and responsibilities and trustee views on climate change.
- Improve trustee knowledge and understanding on climate risk and opportunities through training.
- Assess the competency of advisers on climate change and identify any skills gaps.

2. Strategy

Identify climate risks and opportunities which will affect the scheme's investment strategy (and where relevant funding strategy) and consider the resilience of the strategy.

Assess over appropriate short, medium and long term time horizons and conduct scenario analysis.

Trustee actions:

- Define short, medium and long term time horizons as appropriate for the circumstances of your scheme.
- On an ongoing basis, identify the climate-related risks and opportunities which are considered to have an effect on the scheme's investment strategy (for defined benefit schemes, this should also include consideration of the impact on the scheme's liabilities, the funding strategy and the covenant of the sponsoring employer).
- Conduct scenario analysis for the scheme's asset portfolio (and for defined benefit schemes also consider the impact on liabilities and the covenant of the sponsoring employer). Assess the resilience of the scheme's investment strategy (and where relevant funding strategy) in such scenarios.

  The analysis must include at least two scenarios where there is an increase in global average temperature, and in one of these scenarios the global average temperature rise selected by the trustees must be between 1.5°C – 2°C above pre-industrial levels.

3. Risk Management

Establish and maintain processes to identify, assess and manage relevant climate risks and opportunities. Integrate into overall risk management processes.

Trustee actions:

- Create a risk register of climate-related risks relevant to the scheme – assessing the likelihood and potential financial impact on the scheme of each of these. This should cover liability and covenant risks, as well as risks relating to investments.
- Assessment should be over different time horizons and should be at the asset-class or key sector level at least, if not more granular.
- Incorporate these risks into a wider integrated risk management approach, considering the interconnections between risks and proportionality to the other risks that the scheme faces.

4. Metrics & Targets

*Select and monitor a minimum of three climate metrics for the scheme's investment portfolio. One metric is to give the total greenhouse gas emissions of the scheme's assets categorised between scope 1, scope 2 and scope 3 emissions (**"Absolute Emissions Metric"**) and another is to give the total CO_2 emissions per unit of currency invested by the scheme (**"Emissions Intensity Metric"**).*

Set a target and measure performance against it for one of the calculated metrics.

Metrics are to be calculated annually and to be used to help identify and assess the climate-related risks and opportunities relevant to the scheme.

Trustee actions:

- Understand metric requirements and the quality of data that is available for the scheme's asset portfolio (to identify data gaps).
- Select a third climate metric to assess (in addition to the two mandatory metrics set out above).
- Set at least one appropriate target. Trustees could consider targets linked to those set by the sponsoring employer or aligned to the Paris Agreement for example.
- Annually measure the scheme's performance against the chosen target and consider whether to retain or replace the target.

TCFD report

The TCFD recommendations encourage the annual disclosure of a TCFD report to increase transparency. This is a mandatory requirement for the largest of schemes captured by the new regulations whereby affected trustees must publish a TCFD report within 7 months of the scheme's first year-end after the regulations apply, and then for each year thereafter where their scheme continues to meet the asset size threshold.

The report is to be signed by the Chair of Trustees and made publicly available on a website, accessible free of charge. The website address is to be included in the scheme's annual report and annual benefit statements to members.

Key challenges

It will be crucial for trustees to identify the climate risks most relevant to their scheme and set targets to manage them going forwards. Reliable metrics are needed to aid trustee investment decision-making.

A key challenge is the lack of greenhouse gas emissions data available from underlying investee companies. Trustees are the end users of this data and are therefore reliant on companies making the information available for asset managers to in turn collate and make available to trustees.

This is exacerbated in private markets where there is no requirement for companies to publish their greenhouse gas emissions data. This is resulting in a lack of consistent and comparable metrics available.

Notwithstanding the above, there is significant progress being made in the industry to improve the availability of this data. The FCA has set out a roadmap towards mandatory TCFD disclosures across listed companies, asset managers, life insurers and FCA-regulated pension providers. There is also progress towards developing global reporting standards and international agreements for mandatory TCFD aligned disclosures.

In the meantime, trustees are required under the Regulations to monitor and report *"as far as they are able"* where it comes to the calculation of metrics and performing scenario analysis. Trustees should use estimations to fill data gaps and perform qualitative analysis where quantitative is not available. Trustees should also explain any exclusions and limitations in the TCFD report and look to improve the reporting over time. Trustees could consider the use of third-party providers but should take a proportionate approach with their costs and efforts to plug data gaps.

Support available

- Statutory guidance has been published to support trustees with the actions to be taken to meet these new regulatory requirements, including guidance from the DWP on what is to be included in a scheme's annual TCFD report.
- The Pensions Climate Risk Industry Group has published non-statutory guidance to help trustees with the assessment, management and reporting of climate-related risks in line with the TCFD recommendations and a 'quick-start' guide as a helpful summary.
- In April 2021, the Pensions Regulator ("tPR") published a new climate change strategy which outlines how it will help regulate compliance with the new requirements. Following a consultation, tPR plans to publish additional guidance to help schemes comply with the new legislation and to integrate the management of climate change risks and opportunities as part of their governance framework.

The Pensions Regulator's new Code of Practice, which is currently under consultation but is expected to become effective in Summer 2022, provides that the trustees of schemes with more than 100 members need to incorporate considerations around climate change into their internal controls, and as part of the 'Effective System of Governance' required under the Code. The new Code of Practice also encourages all scheme trustees to consider environmental factors as part of their investment decision-making, although this is not mandated.

Get in touch

If you would like to discuss how Deloitte can support you with aligning your pension scheme with the recommendations of the TCFD, feel free to get in touch with our specialists or your usual Deloitte contact.

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